IT 99-3
Tax Type: Income Tax
Issue: Net Operating Loss (General)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS **v.** **ABC, INC.** **Taxpayer**	**Docket No. 98-IT-0043** **FEIN: 35-1-09684**

FINAL ADMINISTRATIVE DECISION REGARDING THE PARTIES' CROSS-MOTIONS FOR SUMMARY JUDGMENT

APPEARANCES:

Kathryn H. Michaelis, Special Assistant Attorney General, for the Department of Revenue of the State of Illinois; Michael R. Gervasio, Kirkland & Ellis for ABC, Inc.

SYNOPSIS:

This matter arose after ABC, Inc. ("New ABC" or "taxpayer") protested a Notice of Denial ("Denial") of taxpayer's claim for refund that the Illinois Department Of Revenue issued to taxpayer regarding tax years ending October 31, 1994 and October 31, 1995.

Following a period of discovery, each party filed a motion for summary judgment. The dispute here involves the carryback of a net operating loss ("NOL") where the stock of a subchapter S corporation was acquired in an IRC Section 338(h)(10) transaction.[1] On the date of acquisition, the subchapter S election terminated and the corporation became a subchapter C corporation. The taxpayer sought to carryback the net operating loss that was generated in post-acquisition year to the earliest year in which the corporation was a subchapter C corporation. The Department denied the taxpayer's claim for refund on the basis that the net operating loss must be carried back three years, which in this case would be to the pre-acquisition subchapter S corporation. As a result of the hearing held, a recommendation for disposition was submitted to me, as Director, for consideration.

ISSUE:

The issue in controversy here is the correctness of a longstanding position of the Department; that Illinois net losses of a Subchapter C corporation that are carried back must carried back the full three years required by IITA Section 207, even if one or more of the carryback years is a year in which the corporation was a Subchapter S corporation. The Department's Administrative Law Judge ("ALJ") recommended that I reject the Department's longstanding position.

Upon due consideration, the recommendation of the ALJ cannot be accepted. In reaching a conclusion that rejects the ALJ's conclusion, I remain mindful of my responsibilities to the taxpayer as well as to the State. My decision is based solely upon those legal conclusions that may be fairly drawn from the competent evidence produced at hearing.

I have reviewed with particularity all evidence offered. Additionally, I have apprised myself of those pertinent provisions of State law and regulations related to Illinois net losses and have considered the entire transcript of record.

[1] 26 U.S.C.A. Section 338(h)(10). Pursuant to Section 338(h)(10) of the Internal Revenue Code, the shareholders of the selling corporation and the purchasing corporation may elect to treat the stock purchase as an asset sale.

With due regard to the recommendation of the administrative law judge, I have determined that a sufficient record of proceedings was made to permit the appropriate review and issuance of a final administrative decision which differs from the initial recommendation, in accord with the provisions of 86 Ill. Adm. Code, Ch. I, Section 200.130. See also *Highland Park Convalescent home v. Health Facilities Planning Commission*, 217 Ill. App. 3d 1088 (2nd District. 1991)

FACTS NOT IN DISPUTE:

1. ABC, Inc. ("Old ABC") was incorporated as a subchapter S Corporation on June 1, 1964. (Dept. Motion, Ex. A)
2. On December 14, 1994, the stock of Old ABC was purchased by XYZ, Inc. (Dept. Motion, Ex. B, C, D)
3. Old ABC, together with its shareholders and the purchasing corporation, made an election under Section 338(h)(10) of the Internal Revenue Code ("Code') which treats the sale of stock as an asset sale. (Dept. Motion, Ex. B, C)
4. Taxpayer generated a net operating loss in the tax year ended October 31, 1996. (Dept. Motion, Ex. H)
5. Taxpayer filed IL-1120-X's for the tax period ending October 31, 1995 carrying back the net operating loss and seeking a refund. (Dept. Motion, Ex. I)
6. Old ABC's federal identification number and corporate name is the same as taxpayer's. (Dept. Motion, Ex A, D, F, No. 1)
7. Old ABC's final tax period was the tax period November 1, 1994 through December 14, 1994. (Dept. Motion, Ex A, D, F, No. 1)

8. New ABC is a subchapter C Corporation. Its first tax period was the tax period December 15, 1994 through October 31, 1995. (Dept. Motion, Ex. G)

CONCLUSIONS OF LAW:

A motion for summary judgment is appropriate where the pleadings, affidavits, and other documents on file show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. 735 ILCS 5/2-1005©; *People ex. Rel. Department of Revenue v. national Liquors Empire, Inc.*, 157 Ill. App. 3d 434 (4th Dist. 1987). Summary judgment is also appropriate when the parties agree on the facts, but dispute the correct construction of the applicable statute. *Bezan v. Chrysler Motors Corp.*, 263 Ill. App. 3d 858, 864 (2nd Dist. 1994). In this case, the only issue is whether the net operating loss generated by the taxpayer in a post Section 338(h)(10) election year must be carried back three years to the pre Section 338(h)(10) election corporation even though that corporation was a subchapter S corporation in the carryback year.

The ALJ recommended rejection of a longstanding position of the Department. The ALJ recommended that I determine that it is inappropriate for the Department to require that Illinois net losses of a Subchapter C corporation that are carried back must be carried back the full years required by Section 207 of the Illinois Income Tax Act, even if one or more of the carryback years is a year in which the corporation was a Subchapter S corporation.

The ALJ concluded that this longstanding position of the Department is incorrect. As a result, the ALJ recommended that summary judgment should be entered for the taxpayer and the Department's motion for summary judgment should be denied.

The ALJ noted that the Department has expressed this position in a number of letter rulings issued by the Department. However, the ALJ characterized the Department's position as a "trap for the unwary," and advised that "the department's letter rulings have no precedential effect." The ALJ engaged in her own independent analysis of the authority for the Department's conclusion and concluded that there was no authority for the Departrment's position. The ALJ then recommended a grant of summary judgment for the taxpayer.

With all due respect tot he Department's ALJ and the Office of the Chief Administrative Law Judge, I disagree with the ALJ's conclusion that the Department's clearly expressed position is incorrect and that this issue somehow presents a "trap for the unwary." The Department has a clearly articulated position on this issue. That position has been articulated in a number of letter rulings. I take official notice of these ruling letters. See e.g., IT 96-0113, IT 96-0138, IT 96-0139.

To the extent that the "ALJ wishes to argue that this position should more properly be in the form of a validly adopted administrative rule, I do not disagree. I direct the Department's General counsel to initiate rulemaking to adopt this policy in rules with dispatch.

The Department's ALJ contends that the Department's letter rulings have no precendential effect. Therefore, she determined that she might ignore these ruling letters in deciding the motion for summary judgment. I am mindful of the fact that it may be argued that as a technical proposition, general information letters are not binding on the Department and as a result it does not matter whether the Department has taken a position in letter rulings. [2 Ill. Adm. Code 1200.120] however, although general information letters are not binding, they are instructive. It would be unfair to taxpayers for the Department to take one position in general information letters and take a contrary position in an administrative hearing. It should be kept in mind that for every taxpayer who obtains a private letter ruling or general information letter from the Department, there any number of other taxpayers who become aware of such letters and rulings through reviewing the Department's Web Site and base their actions upon the guidance they receive from those letters. Revoking a clearly stated policy of the Department through issuance of an administrative hearing decision can only serve to generate confusion and make it difficult for taxpayers to attempt to determine how to conform their actions to the requirements of the Department.

On the basis of the above, it is my determination as Director that the recommendation of the administrative law judge regarding the disposition of this case is rejected as inconsistent with prevailing law. It is therefore ordered that summary judgment shall be entered for the Department.

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Glen L. Bower
Director of Revenue

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STATE OF ILLINOIS
DEPARTMENT OF REVENUE
ADMINISTRATIVE HEARINGS DIVISION
CHICAGO, ILLINOIS

ABC, INC., **Petitioner** **v.** **THE DEPARTMENT OF REVENUE OF THE STATE OF ILLINOIS**	**No. 98-IT-0043** **Linda K. Brongel** **Administrative Law Judge**

RECOMMENDATION FOR DISPOSITION REGARDING THE PARTIES' CROSS-MOTIONS FOR SUMMARY JUDGMENT

This matter arose after ABC, Inc., ("ABC" or "Taxpayer") protested a Notice of Denial ("Denial") of taxpayer's claim for refund that the Illinois Department of Revenue ("Department") issued to taxpayer regarding tax years ending October 31, 1994, and October 31, 1995.

Following a period of discovery, each party filed a motion for summary judgment. The dispute here involves the carryback of a net operating loss ("NOL") where the stock of a subchapter S corporation was acquired in a §338(h)(10) transaction.[2] On the date of acquisition, the subchapter S election terminated and the corporation became a subchapter C corporation. The taxpayer sought to carryback the net operating loss, which was generated in a post-acquisition year to the earliest year in which corporation was a subchapter C corporation. The Department denied taxpayer's claim for refund on the basis that the net operating loss must be carried back three years, which in this case would be to the pre-acquisition subchapter S corporation. I have reviewed the parties' motions, the exhibits attached thereto, and memoranda filed regarding the motions. I am including as part of this recommendation a summary of the material facts not in dispute. I recommend summary judgment be entered for the taxpayer and Department's motion for summary judgment be denied.

FACTS NOT IN DISPUTE:

1. ABC, Inc. ("Old ABC") was incorporated as a subchapter S corporation on June 1, 1964. (Dept. Motion, Ex. A)
2. On December 14, 1994, the stock of Old ABC was purchased by XYC, Inc. (Dept. Motion, Ex. B, C, D)
3. Old ABC, together with its shareholders and the purchasing corporation, made an election under §338(h)(10) of the Internal Revenue Code ("Code") which treats the sale of stock as an asset sale. (Dept. Motion, Ex. B, C)
4. Taxpayer generated a net operating loss in the tax year ended October 31, 1996. (Dept. Motion, Ex. H)
5. Taxpayer filed IL-1120-X's for the tax period ending October 31, 1995 carrying back the net operating loss and seeking a refund. (Dept. Motion, Ex. I)
6. Old ABC's federal identification number and corporate name is the same as taxpayer's. (Dept. Motion, Ex. D, Nos. 2, 3)
7. Old ABC's final tax period was the tax period November 1, 1994 through December 14, 1994. (Dept. Motion, Ex. A, D, F, No. 1)
8. New ABC is a subchapter C corporation. Its first tax period was the tax period

[2] 26 U.S.C.A. §338(h)(10). Pursuant to §338(h)(10) of the Internal Revenue Code, the shareholders of the selling corporation and the purchasing corporation may elect to treat the stock purchase as an asset sale.

9. New ABC is a subchapter corporation. Its first tax period was the tax period December 15, 1994 through October 31, 1995. (Dept. Motion, Ex. G)

CONCLUSIONS OF LAW:

A motion for summary judgment is appropriate where the pleadings, affidavits, and other documents on file show that there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law. 735 ILCS 5/2-1005(c); People ex rel. Department of Revenue v. National Liquors Empire, Inc., 157 Ill. App. 3d 434 (4th Dist. 1987). Summary judgment is also appropriate when the parties agree on the facts, but dispute the correct construction of the applicable statute. Bezan v. Chrysler Motors Corp., 263 Ill. App. 3d 858, 864 (2nd Dist. 1994). In this case, the only issue is whether the net operating loss generated by the taxpayer in a post-§338(h)(10) election corporation even though that corporation was a subchapter S corporation in the carryback year.

ABC, Inc., ("Old ABC") was incorporated as a subchapter S corporation[3] in 1964. On December 14, 1994, its stock was purchased by an unrelated corporation. Old ABC, together with its shareholders and the purchasing corporation ("New ABC") elected under §338(h)(10) of the Internal Revenue Code to treat the stock sale as an asset sale. Old ABC's final tax period was November 1, 1994 through December 14, 1994, the acquisition date. The acquisition of Old ABC's stock caused a termination of the subchapter S election, and new ABC's first tax period as a subchapter C corporation was December 15, 1994 through October 31, 1995.

During the tax period ended October 31, 1996, New ABC incurred a net operating loss which it sought to carry back to its first year as a C corporation, the year ended October 31,

[3] The provisions regarding subchapter s corporations are found in the Internal Revenue Code at §1361 et seq. The term "subchapter S" refers to the division of the Internal Revenue Code containing §§1361 through 1379.

1995. The Department of Revenue denied taxpayer's claim on the basis that §207 of the Illinois Income Tax Act ("IITA")[4] mandates that net operating losses be carried back tot he earliest of three years:

> Net Losses. (a) If…the taxpayer's net income results in a loss, such loss shall be allowed as a carryover or carryback deduction in the manner allowed under Section 172 of the Internal Revenue Code.[5]

For the tax years at issue, Section 172 provides that net operating losses be carried back three years and forward fifteen.[6]

The controversy here involves two issues: the proper treatment of a net operating loss after the termination of a subchapter C corporation to a subchapter S corporation. ABC, Inc., was originally formed as a subchapter S corporation. A subchapter S corporation is, in the simplest terms, a pass-through entity for tax purposes. If a subchapter S corporation incurs a loss, that loss is passed through to its shareholders. In contrast, a subchapter C corporation (a regular corporation) is a distinct taxable entity. If a subchapter C corporation incurs a net operating loss, it is carried back three years and forward fifteen years, in accordance with §172 of the Internal Revenue Code, to offset income earned by that corporation in those other years.

Although Illinois recognizes the federal law regarding S corporations, their treatment for Illinois tax purposes is somewhat different. Subchapter S corporations are subject to two types of taxation: their income is subject to tax directly for replacement tax purposes, and their shareholders are subject to tax on their income on a flow-through basis. Therefore, even though a subchapter S corporation is not directly subject to tax by the IRS, it will be subject to tax at a rate of 1.5% (the replacement tax) by the state of Illinois.

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[4] **ILCS** 5/101 et seq. Unless otherwise noted, reference to sections are to the Illinois Income Tax Act.
[5] 26 U.S.C.A. §172.

The Department allows subchapter S corporations to carryback and carryover NOL's in order to offset income for purposes of the replacement tax. Where a C corporation has a NOL, and the corporation was an S corporation in s a carryback year, the Department has taken the position that C corporation's NOL [7.3% combined tax rate] will be used to offset the S corporation's replacement tax income [1.5% tax rate], and no offset will be allowed against the individual shareholder's taxable income. *See, e.g.*, IT 96-0113; IT96-0138; IT 96-1039. The Department's position is certainly a trap for the unwary. The taxpayer in this situation will lose the greater part of the benefit of the NOL by electing to carry the NOL back rather than forward to offset other C corporation income. The real question here, however, is whether the Department's position is supported by statute, since the Department's private letter rulings have no precedential effect. <u>Union Electric Co. v. Dept. of Revenue</u>, 136 Ill.2d 385 (1990).

The Department has cited its own regulation, 86 Admin. Code ch. I, Sec. 100.2330 to support its position. According to Reg. §100.2330(a),

> Years to which Illinois net losses may be carried. IITA Section 207 provides that a carryback or carryover deduction shall be allowed in the manner allowed under Section 172 of the Internal Revenue Code. <u>The federal rules concerning the years to which a loss may be carried are contained in Section 172(b) of the Code and in Treas. Reg. Sec. 1.172-4(a)(1).</u> (emphasis added)

The underlined language, however, concerns the <u>years</u> to which losses may be carried. Both Section 172(b) of the Internal Revenue Code and Treas. Reg. §1.172-4 are headed "<u>Years</u> to which losses may be carried." Since Reg. §100.2330(a) is consistent with §207, providing that losses are to be carried over or carried back in the manner allowed under §172 of the Internal Revenue Code, it is necessary to look at §172 and the regulations thereunder in their entirety.

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[6] Effective for tax years beginning after 8/5/97, the carryback period has been reduced to two years and the carryforward period has been increased to twenty years.

Treas. Reg. § 1.172-1(f) deals with the application of the net operating loss, not the years to which it may be carried. Treas. Reg. § 1.172-1(f) provides a specific rule for the carryover or carryback of a NOL from a year in which a corporation is a subchapter C corporation to a year in which a corporation is a subchapter S corporation (also referred to as electing small business corporations):

> In determining the amount of the net operating loss deduction of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation was an electing small business corporation under subchapter s (section 1371 and following), chapter 1 of the Code. In applying section 172(b)(10) and (2) to a net operating loss sustained in a taxable year in which the corporation was not an electing small business corporation, a taxable year in which the corporation was an electing small business corporation is counted as a taxable year to which such net operating loss is carried back or over. However, the taxable income for such year as determined under section 172(b)(2) is treated as if it were zero for purposes of computing the balance of the loss available to the corporation as a carryback or carryover to other taxable years in which the corporation is not an electing small business corporation. See section 1374 and the regulations thereunder for allowance of a deduction to shareholders for a net operating loss sustained by an electing small business corporation.

By deeming the taxable income of the S corporation to be zero in a carryback year, this provision has the effect of prohibiting a carryback form a C corporation year to an S corporation year.[7]

Since §207 provides for NOL carryovers and carrybacks in the manner allowed under §172 of the Internal Revenue Code, and Treas. Reg. §1.172-1(f) prohibits the carryover or carryback of a net operating loss from a year a corporation was a C corporation to a year in

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[7] In the federal context, this is a reasonable result. Since an S corporation is a flow-through entity, if the net operating loss of a C corporation was carried back to an S corporation, the NOL would pass directly to the individual shareholders in the earliest carryback year.

In addition, §1371(b)(1) of the Internal Revenue Code provides further authority that losses may not be carried from a C corporation year to an S corporation year. According to §1371(b)(1):

> From C year to S year. No carryforward, and no carryback, arising for a taxable year for which a corporation is a C corporation may be carried to a taxable year for which such corporation is an S corporation.

See, also, Mitchell v. Commissioner, T.C. memo 1990-617, 60 T.C.M. 1368 (1990). The court found that the prohibition against the carryback of a NOL to a year in which a corporation is a S corporation was implicit in §1374 and the regulations thereunder prior to the enactment of §1371, and held that no part of a loss incurred by a C corporation could be carried back to an S corporation. *Id.* At pp. 1378-79.

which a corporation was a subchapter S corporation, I conclude that as a matter of law, the net operating loss may only be carried back to the earliest year in which the corporation was a subchapter C corporation. I recommend that the Department's motion be denied, the taxpayer's motion be granted, and judgment be entered in favor of the taxpayer.

In light of the foregoing, it is unnecessary to address whether a corporation electing under §338(h)(10) must carryback a net operating loss to a pre-§338(h)(10) acquisition year.

WHEREFORE IT IS ORDERED THAT:

1. Taxpayer's motion is hereby granted, and summary judgment is entered for the taxpayer.
2. Department's motion is denied.
3. Taxpayer's claim for refund be allowed in full and this matter is concluded.

Date: 11/10/98

Linda K. Brongel
Administrative Law Judge